

APPENDIX XII-8
BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D.C. 20551

June 1, 1970

Mr. Woodward Kingman, President
Government National Mortgage Association
Department of Housing and Urban Development
Washington, D.C. 20410

Dear Mr. Kingman:

This is in response to your letter of May 8, 1970, asking for the Board's views on certain questions relating to securities (1) issued by a member bank, (2) based on and backed by a pool of mortgages insured by the Federal Housing Administration or the Farmers' Home Administration, or insured or guaranteed by the Veterans' Administration, and (3) guaranteed by the Government National Mortgage Association pursuant to section 306(g) of the National Housing Act (12 U.S.C. 1721).

The Board understands that securities issued under the mortgage-backed pass-through program are of two types: (1) "straight pass-through" and (2) "modified pass-through." Under the straight pass-through arrangement, the issuer (the member bank) promises to pay the holder only his proportionate share of the proceeds of principal and interest as collected on mortgages in the pool. Under the modified pass-through arrangement, the issuer promises to pay all installments of principal and interest on the securities as they become due, irrespective of whether collections on the mortgages are sufficient for such payments. GNMA guarantees timely payment of principal and interest on the securities in accordance with the terms of the securities.

The holder of a security has recourse against the issuer for failing to make payments on the securities to the extent that collections on the mortgages are available. However, the holder has no recourse against the issuer or any of its assets in the event the issuer does not pay when collections are insufficient to meet payments due on the securities, despite the promise of the issuer referred to in the preceding paragraph. The holder's recourse in that event is solely against GNMA.

You first ask whether the securities are eligible as collateral for advances by Reserve Banks to member banks. Securities that are fully guaranteed by GNMA are eligible for purchase by the Federal Reserve and, therefore, are eligible as collateral for advance by Reserve Banks. (12 CFR 201.108; 1968 Federal Reserve Bulletin 1012). All payments of principal and interest on the modified pass-through securities are so guaranteed and, therefore, those securities are eligible for Federal Reserve purchase and advances. However, the guarantee applicable to the straight pass-through securities only assures the holder

that collections on the mortgages will be remitted in accordance with the terms of the security and does not guarantee full payment of principal and interest on the security. Therefore, the latter securities are not eligible for advances by Reserve Banks at the basic rate, although they may serve as collateral for advances under section 10(b) of the Federal Reserve Act at an interest rate 1/2 per cent higher than the basic discount rate.

Second, you ask whether a member bank that issues the securities will have a deposit liability subject to Regulation Q as a result of its promises as to payments on the securities. Section 217.1(f) requires that, subject to specified exceptions, a member bank shall treat as a deposit liability any obligation undertaken by it principally as a means of obtaining funds to be used in its banking business. Based on the Board's understanding of the nature of the bank's promises and the holder's lack of recourse against the bank, as set forth above and confirmed by Mr. Frum of your staff in a meeting with Messrs. Hexter and Sanders of the Board's staff, a bank that issues mortgage-backed securities of the pass-through type does not have an obligation with respect to such securities within the coverage of section 217.1(f) of Regulation Q (or of section 204.1(f) of Regulation D, relating to member bank reserve requirements). The holder has no right to require the bank to make payment on the securities out of its own funds, nor does the operation of the pool in effect result in the holder having that right. Accordingly, the member bank's promises included in the mortgage-backed securities issued by it and guaranteed by GNMA do not give rise to a deposit liability subject to Regulation Q.

Third, you ask whether a member State bank that issues the securities must include on its books any indication of a liability with respect to them. Again, in view of the nature of the bank's promises and the holder's remedies, a member State bank need not include in its statement of condition any indication of a liability with respect to the securities, although it might wish to make a footnote explanation of its participation in the securities program and its practices as to payments on the securities issued by it.

Finally, you ask whether the foregoing answers would be the same for subsidiaries of member banks. Under the Board's interpretations, a member bank may perform, through a wholly-owned subsidiary, functions the bank is empowered to perform directly. Such a subsidiary is subject to the same restrictions as the parent and is treated by the Board the same as the bank. (12 CFR 240.141; 1968 Bulletin 681). Therefore, mortgage-backed securities issued by a wholly-owned subsidiary of a member bank are the equivalent of securities issued by the member bank itself, and the foregoing answers apply to securities issued by a member bank directly or indirectly through a wholly-owned subsidiary.

Very truly yours,

/s/ Kenneth A. Kenyon
Kenneth A. Kenyon
Deputy Secretary